

Facilitating securities transactions with blockchain: a regulatory case study

Presented by
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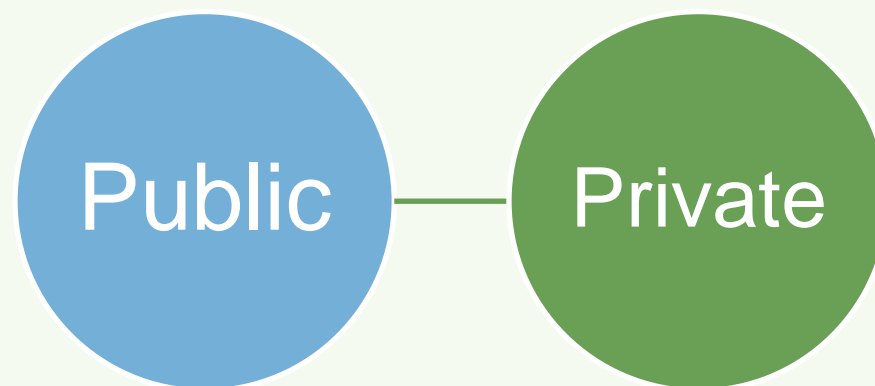
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Source of Law

- Securities Act of 1933
- Securities Exchange Act of 1934
- Trust Indenture Act of 1939
- ...
- Securities and Exchange Commission



Players

- Central Securities

- Custodian Banks

- Depositories

- Trustees

- Broker-Dealers

- Transfer Agents

- Exchanges and ATSs

- Underwriters

Alternative Trading Systems

An “**alternative trading system**” means:

any organization, association, person, group of persons, or system

“That constitutes, maintains, or provides a market place or facilities for **bringing together purchasers and sellers of securities** or for otherwise performing with respect to securities the functions commonly performed by a stock exchange”

AND

“That **does not** (i) **set rules governing the conduct of subscribers** other than the conduct of such subscribers' trading on [the ATS]; or (ii) **discipline subscribers other than by exclusion from trading**”*

17 CFR § 242.300(a)(1)-(2).

* An organization that set rules governing subscribers may be an exchange, rather than an ATS

Alternative Trading Systems

With limited exceptions, a securities trading system meeting the definition of an alternative trading system must:

- Register as a **broker-dealer**

OR

- Register as an **exchange**, and become an SRO

Broker Dealer Requirements:

- Registration on Form BD
- FINRA membership
- Capital requirements
- Annual audit and financial reports
- Use of customer assets and reserve account
- Compliance with margin regulations
- Trade settlement
- Maintenance of books and records
- Trade confirmations
- Reg NMS rules (equity trading) and Reg SHO rules (short sales)
- Anti-fraud and anti-manipulation rules
- Regulatory reporting

Clearing Agency

An “**clearing agency**” means any person, *inter alia*:

“who **acts as an intermediary** in making payments or deliveries or both in connection with **transactions in securities**”

OR

“acts as a custodian of securities in connection with a system ... whereby all securities of a particular class ... may be transferred, loaned, or pledged **by bookkeeping entry without physical delivery** of securities certificates”

OR

“who . . . otherwise **permits or facilitates the settlement of securities transactions** ... without physical delivery of securities certificates”

SEA § 3(a)(23)(A).

Clearing agencies are subject to registration, SRO status and extensive regulatory requirements.

Transfer Agent

An “**transfer agent**” means:

any person who engages **on behalf of an issuer** of securities or on behalf of itself as an issuer of securities in, *inter alia*:

“registering the transfer of such securities”

OR

“transferring record ownership of securities **by bookkeeping entry without physical issuance** of securities certificates”

SEA § 3(a)(25).

Transfer agents with respect to certain securities are subject to registration and other regulatory requirements.

Good Control Location

A broker-dealer must maintain physical possession or “control” of fully-paid and excess margin securities held for customer accounts.

“**Control of securities**” for this purpose generally includes:

- Held by a clearing corporation or custodian bank for the BD
- Carried for the BD by another BD in control of the securities
- Custodied with certain foreign custodians approved by the SEC
- Such other locations as the [SEC] may “designate to be adequate for the protection of customer securities”

17 CFR § 240.15c3-3(c)

Blockchain Regulation

“One key regulatory issue **is whether blockchain applications require registration** under existing Commission regulatory regimes, such as those for **transfer agents or clearing agencies**. We are actively exploring these issues and their implications. Our Advanced Notice of Proposed Rulemaking and Concept Release on transfer agent regulations issued last December, for example, asked for public comment on the use of blockchain technology by transfer agents and how such systems fit within federal securities regulations. The insight from the comment process will help us evaluate how to best regulate these new innovations, and we encourage comment from all constituents.”

- SEC Chair Mary Jo White (March 31, 2016, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative)

“A new technology, the blockchain or distributed ledger system, is being tested in a variety of settings, to determine whether it has utility in the securities industry. **What utility, if any, would a distributed public ledger system have for transfer agents, and how would it be used?** What regulatory actions, if any, would facilitate that utility? How would transfer agents ensure their use of or interaction with such a system would comply and be consistent with federal securities laws and regulations, including the transfer agent rules? Please explain.”

SEC Release No. 34-76743 (Dec. 22, 2015).

Blockchain Regulation

OFFERINGS

- Public
 - Overstock.com's effective S-3 shelf indicates its plans to use blockchain technology to publicly issue “**digital securities**”
- Private
 - Overstock cryptobonds
 - Nasdaq & Chain

Blockchain, Virtual Currency, and Payment Systems Experience

A Long History at the Leading Edge of Payment Systems

Members of our team have:

- Represented companies such as Visa, Green Dot, GCPS (a consortium of six major international banks created to provide a global payments solution for multinational corporations), and CheckFree that have required us to deal with cutting edge technological, regulatory and payments issues.
- Worked closely with the FDIC, Federal Reserve, OFAC, FinCEN, state money transmitter regulators and international regulatory bodies as they have tried to come to grips with these technologies.
- Educated both regulators and legislators about looming issues.
- Assisted our clients in developing a robust compliance environment.

Davis Polk has advised several clients on the evolving regulatory treatment of virtual currencies and blockchain. Examples include:

- Advising banking organizations on investments into and potential banking relationships with blockchain companies and consortiums.
- Advising a leading Bitcoin investment vehicle and its sponsor.
- Advising U.S. and foreign Bitcoin exchanges on structuring activities to fall outside CFTC jurisdiction.
- Advising a U.S. Bitcoin mining company on relevant regulatory law and structuring investments.
- Providing counsel to a creator of a cryptocurrency on regulatory and legal obligations and risks.
- Our lawyers have analyzed Bitcoin from the perspective of securities law, commodities / derivatives law, and insolvency law as well as BSA/AML/OFAC.
- A Financial Institutions Group associate, Reuben Grinberg, wrote the first widely cited academic and legal review of Bitcoin and has written extensively on the topic and been quoted frequently in the media. Before joining Davis Polk, Mr. Grinberg programmed trading server software for Bridgewater Associates.
- Other members of our team have experience as Bitcoin entrepreneurs and have worked on one of the SEC's first reviews of the applicability of existing securities laws to Bitcoin and Bitcoin-denominated investment vehicles.
- Our experience with Bitcoin and other cryptocurrencies is part of our broader experience at the leading edge of developments in financial markets and in advising clients on the creation and use of new financial products and markets.

Virtual Currency, Blockchain and Payment Systems Experience

Davis Polk “BitLicense” Visual Memo

Praise for our proposed rule memo: “This is the best and most comprehensive overview of the BitLicense, its provisions, its pitfalls, and how it affects the various actors in the bitcoin ecosystem. Thanks to Davis Polk for sharing. (Of course, only lawyers could break down 40 pages of regulations into a 43 page presentation...but it’s worth the read nevertheless.)”

-Ryan Selkis, Most Insightful Journalist, Blockchain Awards presented by Bitcoin Foundation and Blockchain.info

New York's Final "BitLicense" Rule: Overview and Changes from July 2014 Proposal

June 5, 2015

What Is Covered Under BitLicense?
Types of Business Activities Subject to BitLicense
§ 200.2(o), (p), (q); § 200.3(c)

“Virtual Currency Business Activity” is defined as any of the following involving New York (as discussed on Slide 13):

1. Receiving virtual currency for transmission or transmitting it (Slide 12)	2. Holding virtual currency for others (Slide 12)	3. Buying and selling virtual currency as a customer business (Slide 13)
4. Exchange services as a customer business (Slide 13)	5. Controlling, administering, or issuing virtual currency (Slide 13)	Exempt from BitLicense (Slide 13)

Exempt from BitLicense (Slide 13):
• Certain entities chartered under New York Banking Law
• State financials, consumers, investors
• More software developers/institutions

Davis Polk bitcoin-reg.com

Blockchain-Reg.com

Blockchain-Reg.com is Davis Polk’s blockchain and virtual currency resources website, tracking the latest developments in this fast-moving area.

Virtual Currency Regulation Resources

Davis Polk

State Regulation

Federal Regulation

Non-U.S. Jurisdictions

Recent Updates

- “Ukraine’s National Bank Issues Bitcoin Warning.” CoaDesk (October 6, 2015)
- BitLicense GBA with Digital Currency Group and Davis Polk, New York, NY (July 16, 2015)
- “California’s Bitcoin Bill Stalled by State Senator.” CoaDesk (September 16, 2015)
- Conference of State Bank Supervisors, State Regulatory Requirements for Virtual

Davis Polk on CFTC’s First Bitcoin Enforcement Action

Davis Polk CLIENT MEMORANDUM

CFTC Brings First Bitcoin Enforcement Action, Further Clarifying U.S. Regulatory Landscape for Virtual Currencies

September 28, 2015

On September 17, 2015, the Commodity Futures Trading Commission settled its first enforcement action involving an unregistered Bitcoin derivatives trading platform. Coinflip, Inc. operated an online trading platform called Derivabit, which connected buyers and sellers of Bitcoin option contracts. Between March and August 2014, Derivabit had approximately 400 users. The settlement order states that Coinflip, Inc. and its founder and CEO, Francisco Riordan, violated provisions of the Commodity Exchange Act and CFTC regulations governing transactions in commodity options, including provisions that require trading platforms that offer swaps to register with the CFTC. Coinflip and its operator were ordered to cease and desist from future violations of the CEA and CFTC regulations, although the order carried no monetary penalties.

The order confirms the regulatory treatment of Bitcoin (and other “virtual currencies” as defined in the order) under CEA and CFTC regulations, consistent with positions taken informally by the CFTC. In line with the view of CFTC Chairman Massad and other CFTC Commissioners, the order states that Bitcoin and other virtual currencies are “commodities” under the CEA. Based on this characterization, the order applies CEA provisions and CFTC regulations that apply to transactions in commodity options and swaps

Davis Polk Presentations on Blockchain

Regulation of Virtual Currency & Blockchains

Presented by
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November 5, 2015

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Mr. Grinberg is an associate in Davis Polk's Financial Institutions Group. His practice focuses on bank regulatory advice, including Dodd-Frank Act regulatory implementation, the preparation of living wills, enhanced prudential standards and intermediate holding company issues, Basel III capital and liquidity issues, and financial institution capital markets and M&A transactions.

In addition, Mr. Grinberg wrote the first widely read and cited academic paper on Bitcoin, and is often cited in the media as an expert on digital currencies. He advises clients on the novel regulatory issues relating to blockchain, Bitcoin and digital currency-based businesses.

Before joining Davis Polk, Mr. Grinberg programmed trading server software for Bridgewater Associates, one of the world's largest hedge funds.

PROFESSIONAL HISTORY

- Davis Polk since 2011

ADMISSIONS

- State of New York

EDUCATION

- B.S., Computer Science, Yale College, 2005
- M.Sc., Computer Science, University of Texas at Austin, 2007
- J.D., Yale Law School, 2011
 - Executive Editor, *Yale Law & Policy Review*

OF NOTE – BITCOIN

- Author of [Bitcoin: An Innovative Alternative Digital Currency](#), Hastings Sci. & Tech. L.J.
- Author of [Bitcoin: Today Techies, Tomorrow the World?](#), Milken Institute Review
- Author of [The Failure of Mt. Gox and Other Recent Bitcoin Catastrophes: Why Banks Should Care](#), CLS Blue Sky Blog
- Interviewed by [Bloomberg TV](#), [NY Times](#), [WSJ Law Blog](#), [Fiscal Times](#), among other publications

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Mr. Rooney is a partner in Davis Polk's Corporate Department, practicing in the Capital Markets Group. He represents both corporate and financial institution clients across a broad range of capital markets transactions, including private placements, IPOs and other equity offerings, and investment-grade, high-yield and convertible debt financings. His practice includes advising U.S. and foreign public companies on general corporate, securities law and governance matters, and public and private companies and financial investors in connection with liability management and debt restructuring transactions. Mr. Rooney has experience across a variety of sectors, including technology, financial, oil and gas, retail and general industrials.

WORK HIGHLIGHTS

Mr. Rooney's recent experience includes the following representations:

IPOs

- The underwriters in connection with the IPOs of First Data, MRC Global and Vantiv
- Cobalt International Energy and Kosmos Energy in connection with their IPOs
- The U.S. Treasury in connection with the "re-IPO" of AIG

OTHER EQUITY OFFERINGS

- The underwriters in connection with follow-on or secondary offerings by AMAG Pharmaceuticals, Centene, Cubic, General Motors, Michael Kors, MRC Global, Vantiv and Virtusa
- Cobalt International Energy and Kosmos Energy in connection with multiple equity offerings
- The issuers and placement agents in connection with numerous pre-IPO private placements

INVESTMENT- AND HIGH-GRADE DEBT

- The initial purchasers in connection with investment-grade debt offerings by KKR and high-grade debt offerings by General Motors

Byron B. Rooney (cont.)

PARTNER

- ExxonMobil and FedEx in connection with their investment-grade debt offerings

HIGH-YIELD DEBT

- The initial purchasers in connection with high-yield debt offerings by DPL, DS Services, Huntington Ingalls, Ipreo Holdings, Michael Foods, NXP and Prospect Mortgage
- Kosmos Energy in connection with multiple high-yield debt offering

CONVERTIBLE DEBT

- The underwriters in connection with convertible debt offerings by AMAG Pharmaceuticals, BroadSoft and SunPower
- Cobalt International Energy and MercadoLibre in connection with their convertible debt offerings

LIABILITY MANAGEMENT AND DEBT RESTRUCTURINGs

- Transactions concerning multiple companies, including Arch Coal, Exxon Mobil, Huntington Ingalls, NXP, Photronics, Sandridge, TRW and Venoco

PROFESSIONAL HISTORY

- Partner, 2014-present
- Associate, 2006-2014

ADMISSIONS

- State of New York

EDUCATION

- LL.B., Bond University Faculty of Law, 2005
 - First Class Honours
- B.Com., Finance, Bond University, 2005
- LL.M., Boston University School of Law, 2006